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REVIEW OF LITERATURE

NEED/IMPORTANCE OF THE STUDY

STATEMENT OF THE PROBLEM

OBJECTIVES

HYPOTHESIS (ES)

RESEARCH METHODOLOGY

RESULTS & DISCUSSION

FINDINGS

RECOMMENDATIONS/SUGGESTIONS

CONCLUSIONS

LIMITATIONS

SCOPE FOR FURTHER RESEARCH

REFERENCES

APPENDIX/ANNEXURE

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GROWTH OF INDIAN COMMODITY DERIVATIVE MARKET OVER THE YEARS AND ITS CURRENT SCENARIO

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ABSTRACT

Commodity market plays an important role in countries like india where a major part of GDP comes from agriculture production. Its contribution is 13.9 percent, that includes Agriculture & Allied Sectors as per the estimates released by Central Statistics Office. Agricultural exports constitute one fifth of the total exports of the country India is ranked to be in the second position in terms of agriculture outputs. The total food grain production has increased approximately to 264.77 million tonnes in 2013-14 (Department of Economics and Statistics) compared to 51 (MT) productions in 1950-51. In terms of spices the Indian market is estimated to be of worth forty thousand crore yearly. It is backed by the increase in the export to US$ 3 billion by 2016-17, with improved quality, packaging, marketing techniques, and a strong distribution network. This also makes country to be the largest exporter in terms of spices. In spite of such improved growth in farm production, still most of the producers are not making comensurate profit, because of lack of producer friendly reforms in commodity derivative markets, low level of awarness in farmers, improper platforms that are not reachable easily by the common producer and inefficient marketing infrastructure. Improvemt in all these mentioned factors, improved reforms and easy accessibility of commodity exchanges would not only benefit the producers but also the sectors that depend on it. In other words India has all the potential to become a major center for trading of commodities and providing benefits to all market participants mainly farmers, unfortunately because of inadequate policy reforms in the agricultural sector, we are way behind in achieving the goal. In order to set up a well developed commodity derivative market in India, obstacles related to fixing the fair prices, maintaining buffer stocks and avoiding farmers vulnerablity towards the price crashes in future, etc needs to be addressed. The present study analyses Growth of Indian Commodity Derivate Market over the years and its issues and concerns.

KEYWORDS
GDP, multi commodity exchange, National Commodity & Derivatives Exchange Limited, National Multi-Commodity Exchange.

1. INTRODUCTION

The origin of derivatives can be traced back to the need of farmers to protect themselves against fluctuations in the price of their crop. From the time it was sown to the time it was ready for harvest, farmers would face price uncertainity. Though the use of simple derivative product, it was possible for the farmer to partially or fully transfer price risks by locking in asset prices. These were simple contracts developed to meet the needs of farmers and were basically a means of reducing risks.

A commodity market is a market where various commodities and derivatives products are traded. Most commodity market across the world, trade in Bullion, Metals, Crude, Agricultural products and other raw materials (like wheat, barley, sugar, maize, cotton, cocoa, coffee, milk products, pork bellies, oil, metals, etc.) and contracts based on them.

A commodity exchange is a place where various commodities and derivatives are bought and sold. Commodities exchange usually trade on commodity future. Different types of contracts based on the sophisticated products can include spot prices, forwards, futures and options on futures. Commodities exchanges usually trade futures contracts on commodities, such as trading contracts to receive a particular commodity in physical form. Speculators and investors also buy and sell the futures contracts at commodity exchanges to make a profit and provide liquidity to the system. The present paper intends to study the growth of Indian Commodity Derivate Market over the years and its issues related to the further development.

Futures trading performs important economic functions viz.,

- Price stabilization-in times of violent price fluctuation-this mechnism dampens the peaks and lifts up valleys i,e. The amplitude of price variation is reduced.
- Leads to integrad price structure throught out the country.
- Facilitates lengthy and complex, production and manufacturing activities.
- Helps balance in supply and demand position throughout the year.
- Encourages competition and acts as a price barometer to farmers and other trade functionaries.

The market functions because of the differing risk profiles of the market participants. The fluctuation in commodity prices represents both, a risk and a potential for profit. The hedgers transfer this risk by foregoing the associated profit potential. The speculators assume this risk in the hope of realizing profits by predicting price movements. The arbitrageurs make the process of price discovery more efficient.

As an example of a hedger, you might be a large corn farmer wanting to sell your product at the highest possible price. However, unpredictable weather may create risk, as well as excess supply that could drive prices down. You could take a short position in corn futures, and if prices fall, you could then buy back the futures at a lower price than you previously had sold them. This would help you offset the loss from your cash crop and help minimize your risk. Of course, if prices rose, you'd loose money on the futures transaction, but the idea is to use futures as a hedge.

2. OBJECTIVES

The objectives of this paper are,

1. To study the growth of Indian commodity derivative markets over the years.
2. To analyze the current scenario and issues related to the Indian commodity derivative market.

3. METHODOLOGY

The present study is based on secondary data collected from the websites of different Commodity Exchanges, Forward Markets Commission, Mumbai, related journals, Government of India reports, and related websites.The study period coveres in the study is 2009-10 to 2014-15. Simple percentages and are used as statistical tool in the present study.

4. INDIAN COMMODITY DERIVATIVE MARKET AND CURRENT SCENARIO

Post independence, the Indian constitution listed the subject of —Stock Exchanges and Future Markets under the union list. As a result, the regulation and development of the commodities futures markets were defined solely as the responsibility of the central government. A bill on forward contracts was referred to an expert committee headed by Prof. A.D. Shroff and select committees of two successive parliaments and finally, in December 1952, the Forward Contracts (Regulation) Act was enacted. This prohibited commodity options and cash settlement on all commodity forwards, and thus in 1953, Forward Market Commission (FMC) was established under he Ministry of Consumer Affairs and Public Distribution.

The Forward Contracts (Regulation) Rules were notified by the central government in 1954. The futures trade in spices was first organised by the India Pepper and Spices Trade Association (IPSTA) in Cochin in 1957. However, in order to monitor the price movements of several agricultural and essential commodities, futures trade was completely banned by the government in 1966. Subsequent to the ban of futures trade, many traders resorted to unofficial and informal trade in futures. However, in India's liberalization epoch in June 1980 Khusro committee recommended the government to reintroduce futures on trading in major commodities, including cotton, jute, kapas, and suggested that steps may be taken for introducing futures trading in commodities like potato, onion etc at appropriate time. The governament accordingly initiated futures trading in potato during the latter half of 1980 in few markets in panjab and uttar pradesh.

Following the introduction of economic reforms in 1991, and the consequent gradual trade and industry liberalization in domestinc and external secters, the Government of India appointed an expert committee on forward markets under the chairmanship of Prof. K.N. Kabra in June 1993. The committee submitted its report in September 1994, the comitee report recommended to re-introduce futures trading that were banned 1966 and expanding its coverage to agricultural commodities, like,

- Basumati Rice
- Ground nut, rape seed/mustard seed, cotton seed, sesame seed, sun flower seed, saf flower seed, copra and soya been, and oils and oil cakes of all of them.
- Castor oil and its oil cake
- Rice bran oil
- Linseed
- Raw jute and jute goods
- Onions
- Silver

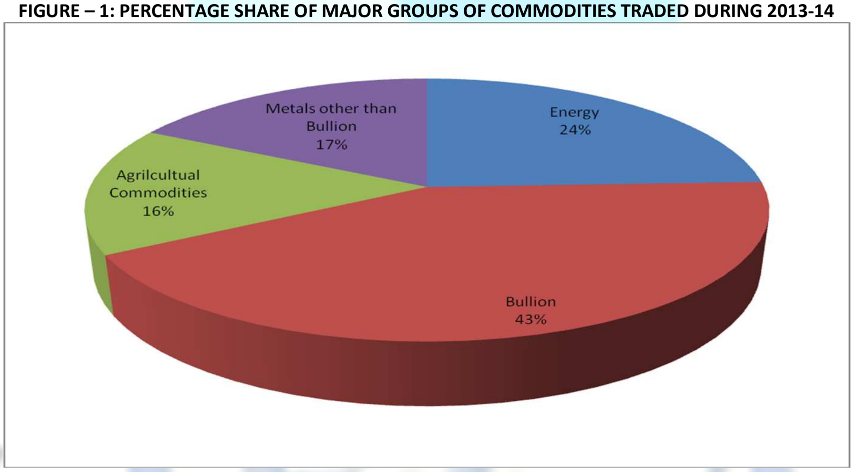
The committee also recomended that some of the existing commodity exchanges perticularly the once in pepper and castor seed may be upgraded to the level of international futures markets.

The liberalized policy being followed by the governament of India and the gradual with drwal of the procurement and distribution channel necessitated setting in place a market mechanism to perform the economic funtions of prize discovery and risk management.

The national agriculture policy announced in July 2000 and the announcement by the finance minister in budget speech for 2002-2003 were indicative of the governament resolve to put in place a mechanism of futures trade/market. As a follow up the government issued notifications on 1.4.2003 permitting futures trading in the commodities, with the issue of these notifications futures trading is not prohibited in any commodity. Options trading in commodity are, how ever presently prohibited.

Currently, there are 6 national level commodity exchanges and 20 regional commodity exchanges in India. The national level exchanges are MCX, NCDEX, NMCE, ICEX, ACE & UCX. These 26 commodity exchanges carry out futures trading. Currently 43 of the 113 commodities that are notified for futures trading are actively traded in 4 national exchanges and 6 commodity-specific exchanges.

FIGURE – 1: PERCENTAGE SHARE OF MAJOR GROUPS OF COMMODITIES TRADED DURING 2013-14



Source: Forward Markets Commission Annual Report 2013-14.

TABLE 1: VOLUME OF TRADING AND VALUE OF TRADE DURING 2013-14 IN MAJOR COMMODITIES

Sr. No	Commodity	Volume (In lakh tonne)	Value (In Rs crore)
A	**Bullion**		
	Gold	0.09	2513697
	Silver	3.94	1795240
	Total for A	4.03	4308938
B	**Metals other than Bullion**		
	Aluminum	129.07	137609.8
	Copper	129.07	785562.2
	Lead	326.49	406971.6
	Nickel	22.05	190796.3
	Steel	1.72	483.71
	Zinc	206.8	231896.2
	Iron	106.42	8040.08
	Total for B	978.37	1761360
C	**Agricultural commodities**		
	Chana/Gram	525.73	164754.9
	Wheat	10.47	1637.22
	Maize	47.3	6168.26
	Maize	417.69	290044.8
	Soy Oil	4.6	41798.11
	Mentha Oil	45.73	24719.8
	Guarseed	8.09	12237.77
	Guar Gum	66.9	4239.66
	Potato	12.53	7537.48
	Chillis	22.48	28917.5
	Jeera	1.47	11310.62
	Cordmom	0.42	1600.7
	Pepper	6.43	10514.94
	Rubber	2442.21	996920.2
	Total for C	3612.03	1602402
D	**Energy**	4238.33	2472095
Grand Total (A+B+C+D)		**8832.76**	**10144795**

Source: Forward Markets Commission Annual Report 2013-14.

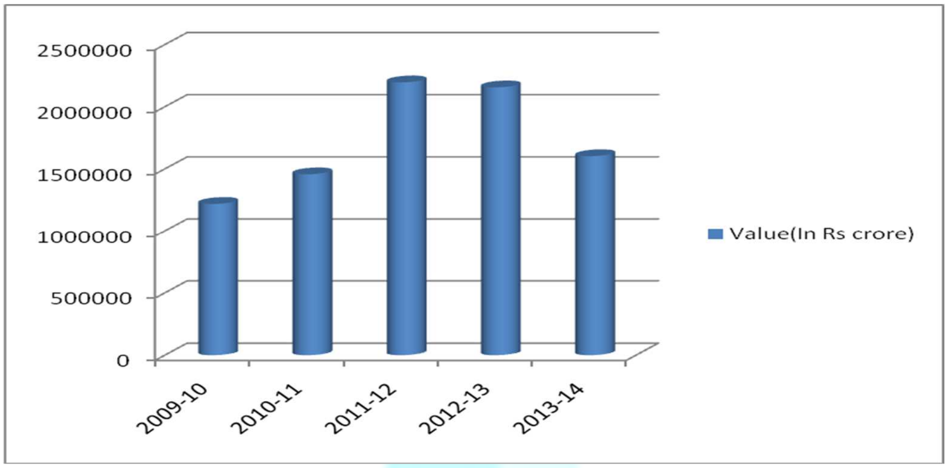
Share of agricultural commodities in the total turnover was seen to be 16.02 percent in 2013-14 and till 2014-15 (up to December 2014)is 18.37 per cent, with food items. The remaining 83.98 turnover was contributed by bullion, metals, and energy contracts for the year 2013-14 and 81.63 per cent for the year 2014-15(up to December 2014). A committee set up by the Ministry of Finance, which submitted its report in April 2014 has observed that hedging efficiency of the commodity futures markets is low. In order to ensure that forward markets in commodities are well regulated and the Indian commodity futures market is compliant with international regulatory requirements, the regulatory framework for the commodity futures market needs to be strengthened at the earliest.

TABLE 2: AGRICULTURAL COMMODITY-WISE VALUE OF TRADE IN THE COMMODITY MARKET DURING 2009-10 TO 2013-14

Agricultural Commodities	2009-10	2010-11	2011-12	2012-13	2013-14
	Value (In Rs crore)				
Chana/Gram	127950.47	126158.29	306411.78	165039.10	164754.94
Wheat	4015.01	3316.88	2661.42	5406.46	1637.22
Maize	790.56	1730.06	2294.48	10938.34	6168.26
Soy Oil	235605.92	345286.26	538383.46	708315.97	290044.79
Mentha Oil	13173.04	60527.10	101410.51	102399.93	41798.11
Guarseed	283431.09	254690.88	338216.19	-	24719.80
Guar Gum	29593.86	49942.57	100515.47	-	12237.77
Potato	4575.74	-	14156.71	5843.42	4239.66
Chillis	1998.17	8493.79	11611.26	11752.80	7537.48
Jeera	33720.04	60864.48	55982.69	65955.88	28917.50
Cordmom	2503.69	10882.04	16373.87	24139.38	11310.62
Pepper	27705.73	84786.09	79518.79	34742.45	1600.70
Rubber	7123.20	23846.92	16697.51	9939.76	10514.94
Other agri	445762.51	411436i.10	611915.37	1011226.92	996920.17
Total	**1217949.03**	**1456389.62**	**2196149.50**	**2155700.42**	**1602401.96**

Source: Compiled from: 1. Forward Markets Commission(FMC) – Annual Report 2009-10, 2010-11, 2011-12, 2012-13, 2013-14.

FIGURE 2: TOTAL VALUE OF TRADE IN AGRICULTURAL COMMODITIES



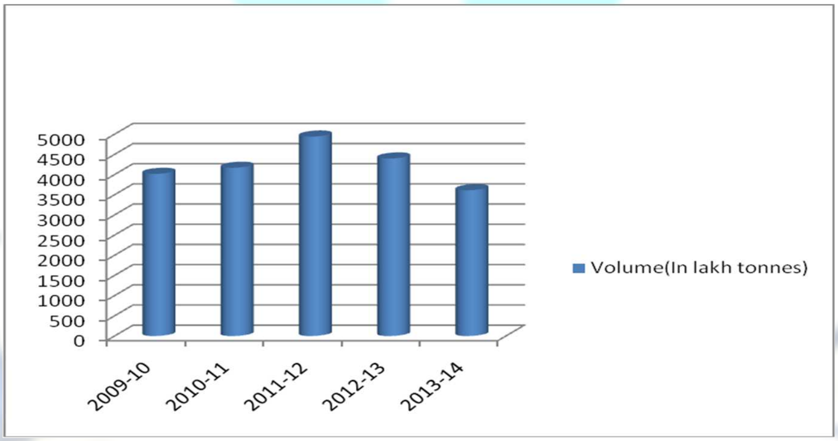
We can observe that the total value of traded agricultural commodity has increased substantially from Rs 1217949.03 crore in 2009-10 to Rs 2196149.50 crore in 2011-12 and decreased to Rs 1602401.96 crore in 2013-14.

TABLE 3: COMMODITY-WISE VOLUME OF TRADE IN THE AGRICULTURAL COMMODITY MARKET DURING 2009-10 TO 2013-14

Agricultural Commodities	2009-10	2010-11	2011-12	2012-13	2013-14
	Volume (In lakh tonne)				
Chana/Gram	530.42	523.59	947.98	389.36	525.73
Wheat	31.77	26.78	22.43	37.50	10.47
Maize	8.41	16.36	19.01	78.21	47.30
Soy Oil	500.62	617.15	802.85	970.81	417.69
Mentha Oil	2.31	6.21	7.11	7.57	4.60
Guarseed	1226.69	1056.04	733.10		45.73
Guar Gum	59.46	83.15	69.02		8.09
Potato	61.63	269.22	229.11	59.54	66.90
Chillis	3.68	11.31	14.07	19.92	12.53
Jeera	26.50	42.53	37.38	45.45	22.48
Cordmom	26.50	0.77	1.91	2.23	1.47
Pepper	19.61	42.25	24.64	8.80	0.42
Rubber	5.81	11.78	7.86	5.62	6.43
Other agri	1514.02	1461.21	2025.61	2773.10	2442.21
Total	**4017.43**	**4168.35**	**4942.09**	**4398.11**	**3612.03**

Source: Compiled from: 1. FMC – Annual Report 2009-10, 2010-11,2011-12,2012-13,2013-14

FIGURE 3: TOTAL VOLUME OF TRADE IN AGRICULTURAL COMMODITIES



Similar to value traded, we can observe that the total volume traded in agricultural commodity has increased from 4017.43 lakh tonnes in 2009-10 to 4942.09 lakh tonnes in 2011-12 and decreased to 3612.03 lakh tonnes in 2013-14.

ISSUES RELATED TO INDIAN COMMODITY DERIVATIVE MARKET

Even though the commodity derivatives market has made good progress in the last few years, the number of commodities allowed for derivative trading have increased, the volume and the value of business has zoomed, but the objectives of setting up commodity derivative exchanges have not been achieved fully and the growth rates witnessed may not be sustainable unless some of the issues are sorted out as soon as possible. Some of the constraints are:

PHYSICAL SETTLEMENT

As physical delivery of underlying commodity at a designated warehouse is required in case of physical settlement. The buyer and seller need to go to the designated warehouses to complete the process of transaction, and then actul goods are carried or transported. Few issues confronting are cost involved in transportation of the commodities along with the restrictions on interstate movements, limits on storage facilities available in different states, octroi and duties impact on the transportation. The process of taking physical delivery in commodities is a complex process and quite different to physical delivery in financial assets.

WAREHOUSING

In case of commodity derivatives however, thre is possibility of physical settlement. Which means that if the seller chooses to hand over the commodity instead of the difference of the cash, the buyer takes physical delivery of the underlying asset, then this requires exchange to make an arrangement with warehouse to handle the selltlements. The efficacy of commodities settlements depends on the warehousing system available. Most international commodity exchanges use certified warehouses (CWH) for the purpose of handling physical settlements. These CWH are required to provide storage facilities for participants in commodities markets and to sertify the quantity and quality of the underlying commodity. The advantage of this system is that warehouse receipt becomes good collateral *(*borrower's pledge of specific property to a lender, to secure repayment of a loan), not for settlement of exchange trades but also for other purposes too. But in India compared to other developed markets warehousing is not so efficient. In India for agricultural produce storage, warehouse facilties are mostly controlled by state and central government and few by private enterprises.

QUALITY OF UNDERLYING ASSETS

A derivatives contract is written on a given underlying asset. Variance in quality is not an issue in case of financial derivatives as the physical attribute is missing. When the underlying asset is a commodity, the quality of the underlying asset is of prime importance. There may be quite some variation in the quality of what is available in the market place. When the asset is specied, it is therefore important that the exchange stipulates the grade or grades of the commodity that are acceptable. Commodity derivatives demand good standards and quality assurance/ certication procedures. A good grading system allows commodities to be traded by specification. Currently, there are various agencies that are responsible for specifying grades for commodities. For example, the Bureau of Indian Standards (BIS) under Ministry of Consumer Affairs specifies standards for processed agricultural commodities whereas AGMARK under the department of Rural Development under Ministry of Agriculture is responsible for promulgating standards for basic agricultural commodities. Apart from these, there are other agencies like EIA, which specify standards for export oriented commodities.

INDEPENDENT REGULATING BODY

Like Securities and Exchange Board of India (SEBI), that regulates the securities markets, there is a need of independent body to control commodity markets, as of now commodity exchanges are controlled by Forward Markets Commission (FMC) which is under the Department of Consumer Affairs (Ministry of Consumer Affairs, Food and Public Distribution) and depends on it for funds. It is very much necessary to provide full powers to FMC in order to develop commodity markets.

LACK OF ECONOMY OF SCALE

Though Currently 43 of the 113 commodities that are notified for futures trading, only few commodities are traded on only specified exchanges and also in practice derivatives are popular for only a few commodities. All this splits volumes and makes some exchanges unviable. This problem can possibly be addressed by consolidating some exchanges. Also, the question of convergence of securities and commodities derivatives markets has been debated for a long time now. The Government of India has announced its intention to integrate the two markets. It is felt that convergence of these derivative markets would bring in economies of scale and scope without having to duplicate the efforts, thereby giving a boost to the growth of commodity derivatives market. It would also help in resolving some of the issues concerning regulation of the derivative markets. However, this would necessitate complete coordination among various regulating authorities such as Reserve Bank of India, Forward Markets commission, the Securities and Exchange Board of India, and the Department of Company affairs etc.

TAX AND LEGAL BOTTLENECKS

There are at present restrictions on the movement of certain goods from one state to another. These need to be removed so that a truly national market could develop for commodities and derivatives. Also, regulatory changes are required to bring about uniformity in octroi and sales taxes etc. VAT has been introduced in the country in 2005, but has not yet been uniformly implemented by all states

5. CONCLUSIONS

As we can see from the analysis of above data, reasonably good growth is registered both in value and volume in Indian commodity derivative market, and with minor exceptions. In spite of this most of the producers are still not making profit. So lot of work in terms of policy liberalization, proper legal system, necessary infrastructure, wide range of training programs are required to make sure that producers catch up with the developed commodity derivative markets.

There are almost 113 commodities notified for trading in commodity market as per the Act 1952, mainly about 25 commodities are traded in the leading commodity exchanges. There should be an opportunity to provide trading of all commodities in all exchanges. According to many studies and surveys conducted by leading exchanges at different places on the awareness campaigns about commodity derivative exchanges show that the involvement of farmers is very less. So there is a need to encourage the involvement of farmers in such programs in collaboration with societies, academic and research institutions and at the same time interference of political and middlemen should be greatly reduced to give the confidence to the farmers to trade their produce in such markets.

As suggested by committee set up by the Ministry of Finance, which submitted its report in April 2014 there is a need of strengthening of regulatory framework for the commodity futures market at the earliest to meet the hedging efficiency of the commodity futures markets to have a well regulated Indian commodity futures market that is in compliant with international regulatory requirements. The Government of India decision to merge FMC with SEBI needs to be appreciated.

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